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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 1271

THE P. DOUGHERTY COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT AND MOTION TO DEFER CONSIDERATION OF THE APPLICATION FOR THE WRIT.

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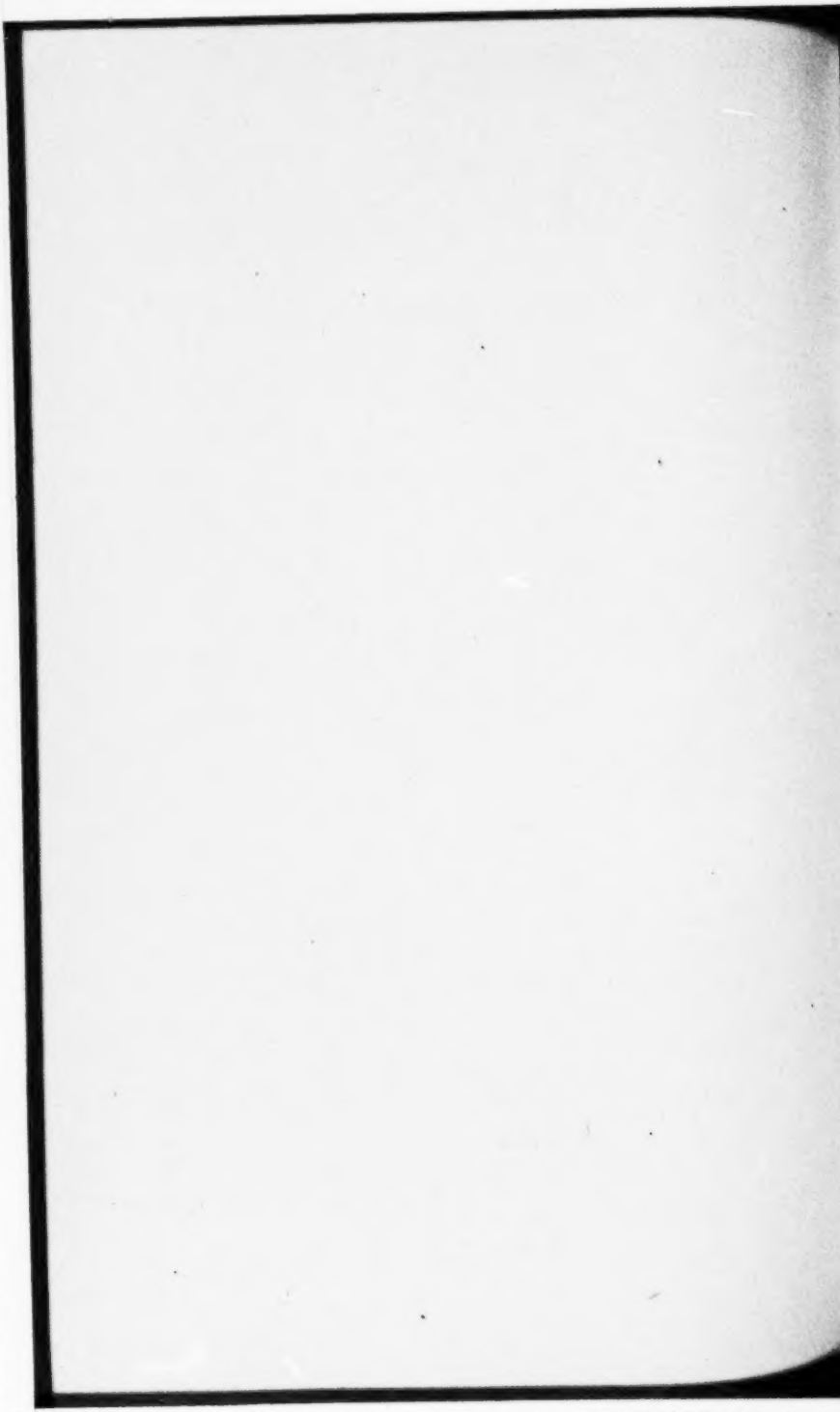

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 1271

THE P. DOUGHERTY COMPANY, A CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petitioner, The P. Dougherty Company, a Maryland corporation, prays that a writ of certiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit, entered December 23, 1946, (R. 24) 4 Cir. 159 F. 2d 269, affirming the decision of The Tax Court of the United States, 5 T. C. 791, redetermining deficiencies in income and excess profits taxes and a penalty imposed by the respondent for the fiscal year ended February 28, 1943 (R. 3, 21).

The certified transcript of the record in this case, including the proceedings in the Circuit Court of Appeals, is furnished herewith in accordance with the requirement in Rule 38, Paragraph I, of the Rules of this Court.

Jurisdiction

The judgment of the Circuit Court of Appeals for the Fourth Circuit was entered December 23, 1946 (R. 24). Time in which to apply for certiorari was extended to April 21, 1947 by the Chief Justice (R. 43). The jurisdiction of this Court is invoked under section 240 of the Judicial Code, as amended, section 347 of title 28 of the United States Code, and under sections 1141 and 1142 of the Internal Revenue Code (53 Stat. 164, 165).

Summary Statement of the Matter Involved

The petitioner acquired seven wooden barges during the period from 1915 to 1918, seven additional barges in 1921 and two steel tugs in 1923, at the total cost of $1,141,620.26. The tugs and barges were new when acquired.

From 1922 to the end of 1940 the tugs and barges were for long periods of time idle and not actually used in the petitioner's business. The tugs were idle continuously from 1930 to the latter part of 1941. They were moored to a dock at Norfolk. Three of the barges were tied up in the James River in 1930 and were never returned to use. The other barges were tied up a part or most of the time. The tugs and the three barges were continuously out of use for more than ten years.

In its returns for the several years prior to the fiscal year ended February 28, 1942, the petitioner entered as a deduction depreciation computed at 5% per annum on the tugs and barges not in use. The returns were nontaxable and were never audited by the respondent and the deduc-

tions for depreciation, taken on property not in use, were not disallowed by the respondent. In the preparation of its income and declared-value profits tax return for the year ended February 28, 1942, and for the purpose of determining whether to file an excess profits tax return on Form 1121, the petitioner sought to restore to cost the amount of the deductions so entered for exhaustion, wear and tear in the prior year returns for the periods during which the tugs and barges had been taken out of use.

The respondent determined that the several vessels, whether or not in use, were subject to depreciation at the rate of 5%, and found that the tugs and barges had become fully depreciated before the beginning of the taxable year February 28, 1943. The Tax Court upheld the determination made by the respondent and the court below affirmed the Tax Court holding that it is sufficient that the tugs and barges "were devoted to the trade or business" (R. 27).

The wood in the stern of one of the barges had rotted and had to be replaced at the cost of $17,593.32. The petitioner deducted the amount as expended for the repair to the vessel. The Tax Court held the expenditure not deductible, relying on section 24 of the Internal Revenue Code, entitled "Items Not Deductible," in which there is the provision that no deduction shall be made for:

> (3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

The Tax Court made the finding that the wood had rotted and had to be replaced. The finding is:

> During 1942 petitioner expended $17,593.32 to replace the stern of the Barge Maryland. It was found that much of the woodwork had rotted and had to be torn out and replaced (R. 12).

The Tax Court made no finding that the expenditure was for a betterment or improvement and, most important, made no finding that "an allowance is or had been made."

The court below held simply that the work done was in the nature of "a permanent betterment or restoration than a recurrent repair or upkeep" (R. 29).

The respondent computed the excess profits tax on the basis of the equity invested capital, defined in section 718 of the Revenue Act of 1940, 54 Stat. et seq., section 718 of the Internal Revenue Code, to include:

> The accumulated earnings and profits as of the beginning of such taxable year.

In his computation the respondent determined the amount of the earnings and profits at the beginning of the taxable year by applying the provision in section 113(b)(1)(B) of the Code that, in determining gain or the deduction for depreciation, all depreciation allowed in excess of the amount allowable in prior years should be deducted in determining the amount of the earnings and profits.

The petitioner contended before the Tax Court and in the court below, that the Congress has not defined, but has left to the courts the determination of the meaning of the "accumulated earnings and profits," as so stated in section 35.718-2 of Treasury Department Regulations 112. The petitioner contended that section 113(b)(1)(B), expressly made applicable to the determination of gain and of the deduction for depreciation, but not made to apply to the determination of the amount of the accumulated earnings and profits by the Congress, should not be so applied by the courts. The petitioner contended that section 718(a)(4) contemplates the use of the true earnings and profits, relying on *Willcutts* v. *Milton Dairy Company,* 275 U. S. 215.

The petitioner timely filed its return of the corporation income and declared value excess profits taxes on Form

1120 and reported a net loss. The petitioner did not file the excess profits tax return on Form 1121. The respondent asserted the 25% penalty for failure to file the return on Form 1121, which assertion the Tax Court and the Circuit Court of Appeals upheld. Five members of the Tax Court dissented, following the decision of this Court in *Spies* v. *United States,* 317 U. S. 492 (R. 18).

In the year 1945 the petitioner operated at a net loss, which it claims it is entitled to carry back to prior years, resulting in an unused excess profits tax carry-back to the year ended February 28, 1943, under section 710(c)(3) of the Internal Revenue Code. After the entry of the judgment by the Circuit Court the petitioner moved to remand for a new trial to permit the petitioner to prove the amount of the unused excess profits credit carry-back to which it is entitled. The Court of Appeals denied the motion without prejudice to proceed to prosecute a claim for refund (R. 40).

The Statutes and the Appropriate Regulations

In each of the revenue acts and in each of the Treasury Department regulations, the allowance of the deduction for exhaustion, wear and tear is limited to property used in the taxpayer's trade or business. In the Revenue Act of 1916, 39 Stat. 759, the provision was made "its use or employment in the business or trade." In section 214(a)(8) of the Revenue Act of 1918, 40 Stat. 1067, the provision is:

> A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business * * *.

This provision has been re-enacted without change in all subsequent acts until the enactment of the Revenue Act of 1942, in which the provision was restated as:

> A reasonable allowance for the exhaustion, wear and tear * * *

(1) of property used in the trade or business, or
(2) of property held for the production of income.

In Regulations 45, Article 162, for the enforcement of section 214(a) (8) of the Revenue Act of 1918, the requirement for the allowance of the deduction for depreciation was:

> The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business.

This requirement has been inserted without change in all subsequent income tax regulations. See Regulations 103 and 111, section 29.23(1)-2 in which there is the further provision, repeated from prior regulations:

> The necessity for depreciation arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of that nature.

The right to claim the deduction for a repair is not by virtue of a specific grant, but is allowed as a business expense under section 23(a) (1) of the Internal Revenue Code, which is that "there shall be allowed as deductions:

> All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

The provision in section 24(a) (3) of the Code, cited by the Tax Court, is that an expenditure to restore property or to make good its exhaustion, is not deductible, if an allowance therefor "is or has been made".

The equity invested capital under section 718(a) (4) of the Revenue Act of 1940 as amended shall be the sum of the money and property paid in, certain stock distributions, and:

> The accumulated earnings and profits as of the beginning of such taxable year.

In section 35.718-2 of Regulations 112, relating to the determination of the equity invested capital, the statement is made:

> The term "accumulated earnings and profits" is not defined in the Internal Revenue Code.

The definition of the equity invested capital in section 718 of the Revenue Act of 1940 does not differ from the definition of invested capital in section 326 of the Revenue Act of 1918, which included:

> Paid in or earned surplus and undivided profits • • •

In article 838 of Regulations 45 for the enforcement of section 326 of the 1918 Act there was the provision:

> Only true earned surplus and undivided profits can be included in the computation of invested capital, and if, for any reason, the books do not properly reflect the true surplus, such adjustments must be made as are necessary in order to arrive at the correct amount.

And in Article 839 of the same regulations, there is the provision that:

> Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that, as at the beginning of the taxable year, the amount of depreciation written off in prior years was insufficient or excessive as the case may be.

The provision in section 291 of the Code, in the case of any failure to file a return, is that the penalty defined therein shall be imposed "unless it is shown that such failure is due to reasonable cause and not due to willful neglect".

The Questions Presented

1. Were the several tugs and barges, during the periods of time when permanently tied up at the dock in Norfolk or in the James River, "used in the trade or business" and subject to exhaustion, wear and tear, within the meaning of the provision of the several applicable revenue acts that there should be deducted from gross income "a reasonable allowance for exhaustion, wear and tear of property used in the trade or business", so as to have become fully depreciated prior to the beginning of the taxable year?

2. The meaning of the provision in subsection (a) (3) of section 24 of the Code, that an expenditure to restore property or to make good its exhaustion is not deductible, if "an allowance is or has been made". If no allowance "is or has been made", is the cost of a mere restoration deductible?

3. In the computation of the invested capital under section 718 of the Code, are earnings and profits at the beginning of the year to be reduced by the amounts of excessive depreciation deducted in returns in prior years? Or is the true surplus to be used as under the Revenue Act of 1918?

4. Should the 25% penalty be imposed for failure to file the excess profits tax return for the fiscal year ended February 28, 1943?

Reasons for Allowance of the Writ

The writ should be granted to review the decision of the court below, because that court has attempted to change the express wording of section 23(1) of the Internal Revenue Code, has failed to consider the full meaning of section

24 and has decided the issues with respect to the computation of the equity invested capital and the imposition of the penalty contrary to decisions of this Court.

I

The Allowance for Exhaustion, Wear and Tear

The provision in section 23(1) is that in order to be deductible the allowance for the exhaustion, wear and tear of property, must result from its use in business. The wording of the section is "used" in the trade or business. The Treasury Department regulations have uniformly provided that the deduction is "limited to property used in the taxpayer's trade or business." These regulations have by now become recognized as having the force of law. *Becker* v. *Anheuser-Busch, Inc.*, 8 Cir., 120 F. 2d 403, cert. denied 314 U. S. 625, 62 S. Ct. 105.

In *Loewers Gambrinus Brewery* v. *Anderson*, 282 U. S. 638, 51 S. Ct. 260, this Court stated that the cost of plant depreciation "is a part of operating expenses necessary to carry on the manufacturing business". In *Buckwalter* v. *Commissioner*, 6 Cir. 61 F. 2d 571, the court stated:

> Only that which is directly employed in carrying on a trade or business falls within the statutory definition.

The petitioner tied up three barges in 1931 which were never returned to use. The two tugs were tied up and not used at all from early in 1931 until the close of 1941 (R.—). The facts here do not differ from those in *United States* v. *Real Estate-Land Title and Trust Company*, 3 Cir. 102 F. 2d 582, affd., 309 U. S. 13, 60 S. Ct. 371, in which a title company had acquired the plants of other companies and closed them. In denying the taxpayer's claim to obsolescence the Third Circuit stated:

> Deductions from gross income cannot be made for obsolescence or depreciation of property unless used

> in the trade or business of the taxpayer in the taxable year in question.

The decision of this Court and of the Third Circuit in the *Real Estate-Land Title* case are reviewed and followed in *Becker* v. *Anheuser-Busch Inc.*, 8 Cir., 120 F. 2d 403. In *Taylor* v. *Commissioner*, 3 Cir., 51 F. 2d 915, cert. denied 284 U. S. 689, the Court held:

> It is the use in the trade or business of "property" that entitles the taxpayer to a deduction. Unless property is used, no deduction is allowable.

In *Helvering* v. *Owens, et al.*, 305 U. S. 468, Mr. Justice Roberts stated:

> The income tax acts have consistently allowed deductions for exhaustion, wear and tear, or obsolescence only in the case of "property used in the trade or business".

The court below held, contrary to the express statutory provision and contrary to the decisions of this Court and of the other Circuit Courts of Appeals, that it is sufficient that the above-mentioned tugs and barges "were devoted to the trade or business which we think was sufficient to bring them within the statutory phrase", following *Kitteredge* v. *Commissioner*, 2 Cir., 88 F. 2d 632 (R. —). The court refused to follow *Helvering* v. *Owens, et al.* and other decisions cited in the note at page 27 of the record, despite the fact that the Tax Court had found that the tugs and barges were so tied up and not in use for more than a ten year continuous period.

It is submitted that the court below has erroneously decided a question of great importance, as the numerous decisions cited in its opinion clearly indicate. It is also submitted that in order to arrive at the conclusion reached the court did not follow the language of the statute, but gave

it a meaning not intended by the Congress in holding that property need not be used in business to entitle the taxpayer to the deduction for depreciation but need merely be devoted to the business. The decision is a clear departure from the wording of the statute. It is not for the court to substitute its definition or requisite for that stated by the Congress. The words "used" and "devote" have entirely different meanings as to the exhaustion of property.

II

The Cost of the Restoration of Property

The Tax Court held that the cost of restoring woodwork that had rotted in the Barge Maryland was not deductible as a repair as an ordinary and necessary business expense under section 23(a) (1) of the Code, because inhibited by section 24(a) (3) which provides that such cost shall not be deducted if an allowance therefor "is or has been made". The Tax Court made not such finding of fact. The Circuit Court of Appeals affirmed the Tax Court and also relied on the provisions of section 24, but based its conclusion on the fact that the restoration would last more than the taxable year. The decision is in conflict with that of the Fifth Circuit in *Zimmern* v. *Commissioner*, 5 Cir., 28 F. 2d 769, in which the cost of restoring a barge that had been sunken was allowed as a repair. The barge was merely, as here, restored to its original condition without any addition, improvement or betterment. The comment of the court below that the restoration of the stern of the barge did not differ from the enlargement of the hatches, clearly discloses an erroneous conclusion.

The writ should be granted as to this point, not so much because of the error of the court below, as because of the importance and the necessity to state the meaning of the provision in section 24(a) (3) that the cost of a restoration

is deductible or not dependent on whether or not an allowance for the cost "is or has been made".

III

THE COMPUTATION OF THE EQUITY INVESTED CAPITAL. ACCUMULATED EARNINGS AND PROFITS.

The Congress has provided, in section 718(a)(4) of the Revenue Act of 1940, that, for the purpose of the computation of the excess profits tax on the invested capital basis, there shall be included in the equity invested capital "The accumulated earnings and profits as of the beginning of such taxable year". The Congress has not stated the meaning of earnings and profits nor has the Congress provided the method by which they are to be determined. This has been recognized by the Treasury Department in its Regulations 112, section 35.718-2. The Congress has not provided that the provisions of section 113(b)(1)(B) shall be followed in the determination of such earnings and profits, but has left the meanings of the words for determination by this Court. Because of this the writ should be granted.

The petitioner submits that the court below erred in holding that the earnings and profits are to be determined by deduction therefrom all depreciation that had been allowed in prior years, as required by section 113(b)(1)(B) for the determination of gain or of the deduction for depreciation, to which alone it is made applicable.

In the Revenue Act of 1918 the Congress in section 326, in terms having the same meaning as in the Revenue Act of 1940, provided that the invested capital should include "earned surplus and undivided profits" at the beginning of the year. The Treasury Department promulgated Regulations 45, articles 838 and 839, that the Congress meant the "true earned surplus and undivided profits" and that

adjustments of depreciation taken in prior years should be made in order to arrive at the true earnings and profits. Section 326 of the 1918 Act was before this Court in *La Belle Iron Works* v. *United States*, 256 U. S. 377, and *Willcutts* v. *Milton Dairy Company*, 275 U. S. 215. In the latter case this Court held that the statute was correctly interpretated in the regulations, and that the words "surplus and undivided profits" are commonly "employed in corporate accounting" to denote "an excess in the aggregate value of all assets of a corporation over the sum of all its liabilities".

The decision of the Circuit Court of Appeals is in conflict with the decisions of this Court, interpreting a similar statutory provision, and, the petitioner submits, the writ should be granted for that reason. The question is of importance in that it should affect most corporations that are required to use the invested capital method for the determination of the excess profits tax.

THE IMPOSITION OF THE PENALTY FOR FAILURE TO FILE RETURN

Under section 729 of the Revenue Act of 1940 a corporation was not required to file an excess profits tax return on Form 1121, unless its net income exceeded the sum of $5,000. The petitioner determined, following the decision in *Pittsburgh Brewing Company* v. *Commissioner*, 3 Cir., 107 F. 2d 155, that its operations were at a loss and proceeded to file its income tax return but did not file an excess tax return. This Court had then not decided *Virginian Hotel Corporation* v. *Helvering*, 319 U. S. 523.

In its majority opinion the Tax Court held that the petitioner had not shown that the failure to file the return was not due to reasonable cause within the meaning of section 291 of the Code. Five judges of the Tax Court, including Judge Smith before whom the case was tried, dissented and based their dissent on *Spies* v. *United States*, 317 U. S. 492 (R. 18).

In not filing the return the petitioner stood on what it considered its legal rights under the decision of the Third Circuit Court of Appeals in the *Pittsburgh Brewing Company* case. Was not the petitioner justified and was not there reasonable cause for its act? Does not the decision below give the statute an effect and purpose that this Court held in the *Spies* case that it should not have?

Conclusion

The petitioner submits that the Circuit Court of Appeals for the Fourth Circuit has decided important questions of public interest and that its decisions are in conflict with express provisions of the statutes and the appropriate regulations and with the several cited decisions of this Court. The petitioner prays that the writ be granted and that the court below be reversed.

THEODORE B. BENSON,
Counsel for Petitioner.

MOTION TO DEFER CONSIDERATION OF APPLICATION FOR WRIT

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petitioner, by its attorney, moves the Court to defer consideration of its application for the writ until such time as the Congress shall have acted on a bill now pending before it to amend section 113(b)(1)(B) of the Internal Revenue Code with respect to the required adjustment to the basis of property for depreciation allowed in prior years, and the petitioner states:

1. The bill, H. R. 1104, was introduced by Representative Hobbs January 20, 1947 and referred to the Committee on Ways and Means. A copy of the bill is attached.

2. Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation, has made his report on the bill to the Chairman of the Committee on Ways and Means and has suggested that the bill be taken up for consideration at such time as other equitable and technical adjustments are being considered. A copy of Mr. Stam's report furnished for the purpose is attached.

3. The petitioner believes that the Congress will at the proper time give favorable consideration to the bill, which would relieve the petitioner of all the tax in controversy.

WHEREFORE, the petitioner moves the Court to defer consideration of its application for the writ.

Respectfully,

THEODORE B. BENSON,
Counsel for Petitioner.

APPENDIX

80th Congress, 1st Session

H. R. 1104

IN THE HOUSE OF REPRESENTATIVES

JANUARY 20, 1947

Mr. Hobbs introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend section 113 (b) (1) (B) of the Internal Revenue Code with respect to the adjustment of the basis of property for depreciation, obsolescence, amortization, and depletion.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subparagraph (1) (B) of section 113 (b) of the Internal Revenue Code, entitled "Adjusted basis", is amended by inserting after the word "allowed" the words "as deductions in computing taxable net income and resulting in a reduction of the taxpayer's taxes" to cause the first sentence thereof to read as follows:

> "(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed as deductions in computing taxable net income and resulting in a reduction of the taxpayer's taxes (but not less than the amount allowable) under this Act or prior income-tax laws."

(b) The amendments made by this Act shall be applicable with respect to taxable years beginning after December 31, 1938.

(c) For the purposes of the Revenue Act of 1932 and all subsequent revenue Acts, the amendments made to the

Internal Revenue Code by section (a) of this Act shall be effective as if they were a part of each such revenue Act on the date of its enactment.

Cloin F. Stam
Chief of Staff
G. D. Chesteen
Asst. Chief of Staff

Congress of the United States

Joint Committee on Internal Revenue Taxation

Washington

March 17, 1947.

Honorable Harold Knutson, Chairman
Ways and Means Committee
House of Representatives
Washington, D. C.

Dear Mr. Knutson:

This is with reference to the letter addressed to you on March 3 by Representative Sam Hobbs, in which he asks your cooperation toward the passage of a bill, H. R. 1104, which he has introduced, relating to deductions for depreciation.

Mr. Hobbs' bill would add the words "as deductions in computing taxable net income and resulting in a reduction of the taxpayer's taxes" after the word "allowed" in section 113(a)(1)(B) of the Internal Revenue Code.

Under the present provisions, in computing the basis of property for the determination of gain or loss on a sale or other disposition, or for determining depreciation, etc., in subsequent years, the original cost or other basis must be reduced by the depreciation, amortization, depletion, etc., *allowed*, but not less than the amount *allowable*, in previous years. Thus, if in a previous year the proper rate of depreciation were 8 percent but the taxpayer had deducted (without correction by the Bureau of Internal Revenue) depreciation at the rate of 10 percent, the 10

percent "allowed" would be deductible now in computing the basis for determining gain or loss on a sale or for subsequent depreciation. On the other hand, if the taxpayer had deducted 7 percent when 8 percent would have been "allowable", the 8 percent that should have been deducted rather than the 7 percent actually deducted would now be deducted in computing the basis for subsequent tax determinations.

Some years ago there was considerable litigation over the question whether depreciation at excessive rates deducted in returns for prior years which indicated a net loss was in fact "allowed" if the deduction did not result in decreased taxes for the years of the deductions. In 1942, in its decision in Virginian Hotel Co. *v.* Helvering (319 U. S. 523), the Supreme Court decided that deductions for depreciation, etc., as shown on a return were "allowed" even though the return showed no net taxable income but a net loss, and even though the Commissioner had accepted the return without examination of the taxpayer's records and returns.

Mr. Hobbs' bill would apply to a situation where in previous years the taxpayer had deducted in his returns an amount of depreciation greater than would be required, if deducted each year, to recover the cost during the useful life of the asset; if, for example, the useful life being 20 years, he had deducted 10 percent instead of 5 percent of the cost. If the excess deduction offset taxable income and thus reduced his taxes for that year the error would stand, but if the excess deduction resulted in a net loss, and so did not have the effect of reducing his taxes for that year, only the correct amount, and not the excess, would be deducted from the original cost or other basis in determining the remaining cost yet to be recovered through subsequent depreciation deductions or to be used as the basis for determining gain or loss on a sale.

Mr. Hobbs' bill is based upon the principle that the current income taxes of a taxpayer should not be more than they otherwise would be because of an error made by the taxpayer in a prior year, from which he derived no tax benefit. There can be little criticism of such a principle

on general logical grounds. This principle is similar to that which led the Congress, in 1942, to provide that amounts collected currently as recoveries of bad debts, taxes, etc., deducted in a previous year should not be viewed as taxable if the previous deduction resulted in no tax benefit to the taxpayer (section 22(b)(12), added by section 116 of the Revenue Act of 1942). Although, in principle, Mr. Hobbs' bill may be acceptable, an important objection that might be raised is the administrative difficulty that would arise from putting it into practise. In view of the carry-back and carry-forward of net losses and unused excess profits credits during recent years, the determination of whether, and to what extent, excess depreciation resulted in a tax benefit might entail considerable reexamination of returns, revenue agents' reports, etc., and the recomputation of depreciation deductions over a long period of years might, in some cases, be a lengthy process.

Since there is considerable justification for the suggested change on equitable grounds, and since there has been a considerable demand for such a change by taxpayers, their attorneys, and tax experts generally, however, it may well be that the Congressional committees having jurisdiction will wish to suggest an amendment similar to that of H. R. 1104 at such time as various equitable and technical adjustments to the income tax structure are being considered.

The bill introduced by Mr. Hobbs makes the suggested change in procedure applicable to all taxable years beginning after December 31 1938. In general, Congress does not look with great favor on proposals for retroactive adjustments, since they lead to the redetermination of tax liabilities in cases otherwise satisfactorily settled. In any case, it would seem unwise to provide for retroactive application to years prior to those as to which, in general, deficiencies may be asserted or refunds claimed (three years from the due date of the return), since only a few taxpayers could benefit and many, equally worthy, would be denied relief. If such a bill as H. R. 1104 were to be passed now, for example, the great mass of taxpayers would be precluded from obtaining relief with respect to their tax liabilities for 1939, 1940, 1941, 1942, and 1943; whereas a

few taxpayers with tax liabilities for one or more of those years yet unsettled because of disputes, litigation, etc. could benefit.

I trust this analysis and comment will be helpful to you and to Mr. Hobbs.

Sincerely yours,

(Signed) COLIN F. STAM,
Chief of Staff.

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In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 1271

THE P. DOUGHERTY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The prevailing (R. 3–18) and dissenting (R. 18–20) opinions in the Tax Court are reported in 5 T. C. 791. The opinion of the Circuit Court of Appeals (R. 24–31) is reported in 159 F. 2d 269.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 23, 1946. (R. 31.) The time for filing a petition for a writ of certiorari was extended to April 21, 1947, by order of this Court dated March 10, 1947. (R. 43.) The petition for certiorari was filed on April 21, 1947.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the taxpayer-corporation is entitled under Sections 23, 113 and 114 of the Internal Revenue Code to a greater deduction for depreciation than was allowed by the Commissioner and the courts below.

2. Whether the amount spent by the taxpayer in rebuilding the stern of a barge was deductible under Section 23 of the Internal Revenue Code as a business expense, as the taxpayer contended, or whether it was a capital expenditure under Section 24 of the Internal Revenue Code, as the Commissioner and the courts below determined.

3. Whether the 25% penalty for failure to file an excess profits tax return was properly imposed under Section 291 of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The Tax Court found the following facts (R. 5–9):

The petitioner (referred to herein as "taxpayer") is a Maryland corporation engaged in the towing and barge transportation business, with its principal offices at Baltimore. It filed

its corporation income and declared value excess profits tax return for the fiscal year ended February 28, 1943, with the Collector of Internal Revenue for the District of Maryland at Baltimore. Taxpayer keeps its books and files its income tax returns on the basis of a fiscal year ending February 28. (R. 5.)

Taxpayer acquired seven wooden barges during the period 1915 to 1918, seven more in 1921, and two steel tugs in 1923. The dates of acquisition and cost of such tugs and barges were as follows (R. 6):

	Date acquired	Cost
Barge *Wilmington*	1915	$51,450.24
Barge *Montank*	1915	51,300.29
Barge *Delaware*	1916	52,141.49
Barge *Baltimore*	1916	49,413.43
Barge *Maryland*	1917	51,966.72
Barge *Providence*	1917	73,280.29
Barge *Annapolis*	1918	72,518.30
Barge *Harford*	1921	90,000.00
Barge *Mayo*	1921	90,000.00
Barge *Allegany*	1921	90,000.00
Barge *Caroline*	1921	90,000.00
Barge *Frederick*	1921	90,000.00
Barge *Garrett*	1921	90,000.00
Barge *Montgomery*	1921	90,000.00
Tug *Ivanhoe*	1923	54,774.75
Tug *Dunmore*	1923	54,774.75
Total		1,141,620.28

The tugs and barges listed above are the only ones to which the depreciation questions raised in this proceeding relate. (R. 6.)

During the years 1940 and 1941 taxpayer expended the following amounts for altering and reconditioning the tugs and barges, which the

parties have stipulated should be capitalized and depreciated at the rate of 10% per annum (R. 7):

Barge *Wilmington*, Oct. 1, 1940	$11,650.00
Barge *Montauk*, Oct. 1, 1940	11,922.86
Barge *Providence*, Nov. 1, 1940	11,871.18
Barge *Baltimore*, Dec. 1, 1940	11,878.93
Tug *Dunmore*, June 10, 1941	34,064.23
Tug *Ivanhoe*, October 31, 1941	42,143.99
Barge *Maryland*, Nov. 1, 1941	15,523.30
Barge *Annapolis*, Nov. 1, 1941	15,262.84
Barge *Delaware*, Dec. 31, 1941	15,465.90

During 1942 taxpayer expended $17,593.32 to replace the stern of the barge *Maryland*. It was found that much of the woodwork had rotted and had to be torn out and replaced. Taxpayer treated this expenditure as ordinary repairs and deducted the cost thereof in its return for 1942. The Commissioner determined that it was a capital expenditure and therefore not deductible in its entirety in that year. (R. 7.)

For all the years prior to 1922, taxpayer computed depreciation on its tugs and barges, both in its books and its income tax returns, on a declining basis at the rate of 10% of the balance at the beginning of each year. A revenue agent who in 1921 made an examination of taxpayer's books for the years 1917 to 1920, inclusive, recommended that this method be changed and that depreciation deductions be taken on a straight-line basis at the rate of 5%. Taxpayer adopted that method in 1922 and has since followed it, both in its books and its returns. For many years taxpayer reported net losses in excess of the depreciation deductions contained in its returns. All of the

depreciation so claimed by the taxpayer in its returns, up to 1942, was allowed by the Commissioner. (R. 7.)

In 1942 taxpayer restored to capital, as excessive depreciation, a portion of the depreciation previously charged off in its books and its returns. Some of its tugs and barges were not in actual use during part or all of the years 1922 to 1942, inclusive. Both of its tugs were idle from early in 1931 until the close of 1941. Three barges were idle continuously from 1931 to 1941, inclusive. Several other barges were idle for all or portions of the years 1930 to 1941, inclusive. During the protracted periods of idleness the tugs were tied up at the Colona shipyard, Norfolk, Virginia, and the barges in the James River near Willcox Farm, all under the care of watchmen. They were all kept painted and in seaworthy condition. According to taxpayer's books of account, the depreciation on the tugs and barges for the time that they were not in use, computed at the rate of 5%, amounted to $530,176.72. Apparently the amount which taxpayer restored to capital represented the depreciation computed on the tugs and barges during the periods of idleness. Its depreciation deductions for 1942 and 1943 were computed on a cost basis, including such restored capital. (R. 7–8.) The 1941, 1942 and 1943 returns showed net losses, depreciation claimed, and depreciation allowed as follows (R. 8):

	1941	1942	1943
Net losses	$35,000.84	$00,779.22	$95,404.88
Depreciation claimed	36,977.50	49,198.62	52,786.72
Depreciation allowed	38,652.39	36,746.60	24,214.74

In computing taxpayer's depreciation for the years 1941, 1942, and 1943, the Commissioner included in the cost basis the remaining original cost of the tugs and barges on hand, with the addition thereto of the cost of reconditioning, which he treated as capital expenditures. He thus allowed a greater depreciation in 1941, before restoration to capital of the prior years' alleged excessive depreciation, than was claimed by taxpayer. (R. 8.)

At the end of taxpayer's taxable year 1941, the original cost of the seven barges acquired during the period 1915 to 1918, inclusive, had been fully written off in taxpayer's books and in its returns, through depreciation deductions. There remained only $3,000 of the original cost of each of the seven barges acquired in 1921 and $5,477.25 of the original cost of each of the tugs. (R. 8–9.)

The taxpayer filed its income and declared value excess profits tax return (Form 1120) for the tax year ended February 28, 1943, but did not file an excess profits tax return on Form 1121. In reporting a loss of $95,404.88 for that year taxpayer deducted, in addition to depreciation in the amount of $52,786.72, a claimed loss on the salvage sale of the barges *Allegany, Caroline,* and *Montgomery* in the amount of $141,000,

and net operating losses for 1941 and 1942 in the total amount of $80,298.06. (R. 9.)

The Tax Court sustained the Commissioner as to all points here involved (R. 9–18), and the Circuit Court of Appeals affirmed (R. 31).

ARGUMENT

1. Section 114 (a) of the Internal Revenue Code provides that the basis for depreciation shall be the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of the property. Section 113 (b) (1) (B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913, for depreciation to the extent allowed (but not less than the amount allowable) under the Code or prior income tax laws.

Both of the courts below held, correctly, we submit, that the taxpayer could not restore to capital in the year 1942 amounts previously charged off and allowed as depreciation deductions, and thus increase its adjusted basis for depreciation under Section 113 of the Internal Revenue Code. In so holding, they took the view that the taxpayer's tugs and barges which lay idle for varying periods during the years 1922 to 1942, inclusive, were nevertheless subject to depreciation because they were kept in usable condition and were ready for use should the occasion arise. In such circumstances there is no

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adequate basis for taxpayer's contention that the properties were not used in trade or business within the meaning of the tax laws (Section 23 (l) (1) of the Internal Revenue Code, Appendix, *infra;* Section 23 (l), Revenue Acts of 1938, 1936, 1934; Section 23 (k), Revenue Acts of 1932, 1928), which provide for the allowance of depreciation deductions with respect to property used in trade or business. The reason is stated as follows in *Kittredge* v. *Commissioner,* 88 F. 2d 632 (C. C. A. 2d) at page 634:

> To read the phrase "used in the trade or business" as meaning only active employment of property devoted to the business would lead to results which we cannot believe Congress intended. For example, one factory of a large industrial plant may lie idle for a year, and in fact suffer depreciation as great, or greater, than that sustained by the factories in operation. To allow no depreciation for the idle factory would be most unfair to the taxpayer, for he must claim the deduction in his tax return for the year when the depreciation occurs, and may not take it in a later year. See *Hardwick Realty Co.* v. *Commissioner,* 29 F. 2d 498, 500 (C. C. A. 2). Hence we think the phrase should be read as equivalent to "devoted to the trade or business"; that is to say, that property once used in the business remains in such use until it is shown to have been withdrawn from business purposes. * * *

And in *Yellow Cab Co. of Pittsburgh* v. *Driscoll*, 24 F. Supp. 993 (W. D. Pa.), the same result was reached. Cf. *United States* v. *Ludey*, 274 U. S. 295; *Beckridge Corp.* v. *Commissioner*, 129 F. 2d 318 (C. C. A. 2d); *United States Industrial Alcohol Co.* v. *Helvering*, 137 F. 2d 511, 517 (C. C. A. 2d); *Herder* v. *Helvering*, 106 F. 2d 153, 162 (App. D. C.), certiorari denied, 308 U. S. 617.

Moreover, under this Court's decision in *Virginian Hotel Corp.* v. *Helvering*, 319 U. S. 523, affirming 132 F. 2d 909 (C. C. A. 4th), it is immaterial that for many early years the taxpayer in the instant case reported net losses in excess of the depreciation deductions which it claimed in its returns. Both of the courts below so held (R. 10–11, 28.)

In support of its application for certiorari the taxpayer relies upon cases (*Becker* v. *Anheuser-Busch, Inc.*, 120 F. 2d 403 (C. C. A. 8th), certiorari denied, 314 U. S. 625; *Gambrinus Brewing Co.* v. *Anderson*, 282 U. S. 638; *United States* v. *Real Estate-Land Title & Trust Co.*, 102 F. 2d 582 (C. C. A. 3d), affirmed, 309 U. S. 13; and *Helvering* v. *Owens*, 305 U. S. 468), which are not at variance with the instant decision. Three of those cases involved claims for "obsolescence" and turned upon the meaning of that term, and the other case (*Helvering* v. *Owens*) involved the basis for computing loss from damage by casualty to property acquired and used for pleasure.

For the same reasons, there is no merit in the taxpayer's further contention (Pet. 8, 12–13) that in the computation of invested capital the alleged excessive depreciation taken in prior years should be restored to capital and the accumulated earnings and profits at the beginning of the taxable year, includible in equity invested capital under Section 718 (a) (4) (Appendix, *infra*), correspondingly increased. Both of the courts below correctly so held. (R. 16, 26–27.)

2. The courts below properly held that the cost of replacing the stern of the barge *Maryland* should be capitalized. This item was not an incidental repair which should be treated as a deductible business expense. It was a major replacement the cost of which should be recovered through depreciation. The regulations are in harmony with this view (Treasury Regulations 111, Section 29.23 (a)–4; Treasury Regulations 103, Section 19.23 (a)–4, Appendix, *infra*) and so are the other available authorities: *Hubinger* v. *Commissioner,* 36 F. 2d 724 (C. C. A. 2d), certiorari denied *sub nom. New Haven Bank* v. *Commissioner,* 281 U. S. 741; *Black Hardware Co.* v. *Commissioner,* 39 F. 2d 460 (C. C. A. 5th), cercertiorari denied, 282 U. S. 841; *Buffalo Union Furnace Co.* v. *Helvering,* 72 F. 2d 399 (C. C. A. 2d).

Moreover, as pointed out by the Circuit Court of Appeals (R. 29), it is peculiarly within

the competence of the Tax Court to determine where to draw the line in cases of this kind, and the decision of the Tax Court should not be disturbed unless manifestly wrong. *Dobson* v. *Commissioner*, 320 U. S. 489; *John Kelley Co.* v. *Commissioner*, 326 U. S. 521.

The taxpayer asserts (Pet. 11) that *Zimmern* v. *Commissioner*, 28 F. 2d 769 (C. C. A. 5th), is in conflict with the decision here. In the *Zimmern* case the court allowed the deduction of the cost of repairs necessary to restore a sunken barge to the condition it was in before it sank; but that case did not involve a major replacement such as the one here, and in any event the decision is difficult to reconcile with the later decision of the same court in the *Black Hardware* case, *supra*, where the cost of raising the floor of a building was held not deductible.

In the circumstances we submit that the decision as to this point is in accordance with the law and the regulations; there is no direct conflict, and no occasion for further review by this Court.

3. The other point as to which certiorari is sought is whether the 25% penalty for failure to file an excess profits tax return was properly imposed. Section 291 of the Internal Revenue Code (Appendix, *infra*) provides for the imposition of the penalty unless it is shown that the failure to file the return was due to reasonable cause and not

to willful neglect. The Tax Court took the view (R. 17) that the evidence did not suggest that the taxpayer was willfully negligent but further held, five judges dissenting, that the failure to file was not due to a reasonable cause within the meaning of the law. In affirming the decision of the Tax Court, the Circuit Court of Appeals said (R. 30–31) that the question is one of fact and peculiarly within the province of the Tax Court (*Commissioner* v. *Lane-Wells Co.*, 321 U. S. 219, 225; *Paymer* v. *Commissioner*, 150 F. 2d 334, 337 (C. C. A. 2d)), and an innocent mistake by a taxpayer which leads him to believe he is not required to file a return is of itself insufficient to show that his failure was due to reasonable cause within the meaning of the statute.

The taxpayer argues (Pet. 13–14) that it determined, following the decision in *Pittsburgh Brewing Co.* v. *Commissioner*, 107 F. 2d 155 (C. C. A. 3d), that its operations were at a loss, and therefore did not file an excess profits tax return. Taxpayer contends here, as it did below, that it was justified in relying on the *Pittsburgh* case. However, it has not been shown that the *Pittsburgh* case, even if correct, would have cut down the taxpayer's income to a point where no excess profits tax return would have been required. Moreover, the *Pittsburgh* case was wrongly decided and it was disapproved by both the Fourth Circuit and this Court in the *Virginian Hotel*

case, *supra*. The Fourth Circuit's decision in that case was rendered on January 2, 1943, and this Court's decision was rendered on June 7, 1943. In the circumstances, we submit that the taxpayer, when it determined its course of action for the taxable year ended February 28, 1943, was not justified in assuming that it could safely follow the *Pittsburgh* case.[1]

4. In conjunction with the petition for certiorari, the taxpayer has moved this Court (Pet. 15) to defer consideration of its application for the writ until such time as Congress shall have acted upon a bill, H. R. 1104, introduced by Representative Hobbs on January 20, 1947, and referred to the Committee on Ways and Means. Apparently this bill has not yet been reported out of committee. On pages 17–20 of taxpayer's petition for certiorari there is printed a copy of Mr. Stam's letter of March 17, 1947, to the Chairman of the Ways and Means Committee which points out the administrative difficulties which would arise if the bill were passed in its present form.

We oppose this motion, and urge that consideration of the taxpayer's application for certiorari should not be delayed pending the final outcome of the bill. The bill undertakes to overcome the effect of the *Virginian Hotel* case and to change the

[1] *Spies* v. *United States*, 317 U. S. 492, upon which taxpayer also relies (Pet. 13), is not at variance with our contentions here. It was a criminal case and it dealt with statutory provisions not here involved.

law only where depreciation has been allowed in excess of that properly allowable and resulted in no tax benefit. It will be noted that the bill does not undertake to change the law as to adjustments in respect to allowable depreciation. Under the decision in the instant case, all of the depreciation here involved was not only allowed but properly allowable, and in this view there is no adequate basis for the application of the bill's provisions. Moreover, no foundation appears for the taxpayer's allegation (Pet. 15) that the passage of the bill would relieve it of all the tax in controversy.

CONCLUSION

The decision is correct; there is no conflict; and the petition should be denied. The application for a postponement of action on the petition for certiorari should also be denied.

Respectfully submitted.

GEORGE T. WASHINGTON,
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LEE A. JACKSON,
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MAY 1947.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(i) *Basis for Determining Loss.*—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), and for bad debts, to be allowed under subsection (k), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property.

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (in-

cluding a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income. * * *

* * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

(26 U. S. C., Supp. V, 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;

* * * * *

(26 U. S. C. 24.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, when-

ever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws.

* * * * *

(26 U. S. C. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

(26 U. S. C. 114.)

SEC. 291. FAILURE TO FILE RETURN.

In case of any failure to make and file return required by this chapter, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the

aggregate. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 per centum addition to the tax provided in section 3612 (d) (1). (26 U. S. C. 291.)

SEC. 718 [as added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, and as amended by Section 218 of the Revenue Act of 1942, c. 619, 56 Stat. 798].

EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its

fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (l) for determining earnings and profits;

(3) *Distributions in Stock.*—Distributions in stock—

(A) Made prior to such taxable year to the extent to which they are considered distributions of earnings and profits; and

(B) Previously made during such taxable year to the extent to which they are considered distributions of earnings and profits other than earnings and profits of such taxable year;

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year; * * *

* * * * * *

(26 U. S. C., Supp. V, 718.)

SEC. 729 [as added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, and as amended by Section 205 of the Revenue Act of 1942, c. 619, 56 Stat. 798].

LAWS APPLICABLE.

(a) *General Rule.*—All provisions of law (including penalties) applicable in respect of the taxes imposed by Chapter 1, shall, insofar as not inconsistent with this subchapter, be applicable in respect of the tax imposed by this subchapter.

(b) *Returns*—

* * * * * *

(2) *No Return Required.*—Notwithstanding subsection (a), no return under section

> 52 (a) shall be required to be filed by any taxpayer under this subchapter for any taxable year for which its excess profits net income, computed with the adjustments provided in section 711 (a) (2) and placed on an annual basis as provided in section 711 (a) (3), is not greater than $5,000 or, in the case of a mutual insurance company (other than life or marine) which is an interinsurer or reciprocal underwriter, is not greater than $50,000.
>
> * * * * *
>
> (26 U. S. C., Supp. V, 729.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:[2]

> SEC. 29.23 (a)–4. *Repairs.*—The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. (See sections 29.23 (l)–1 to 29.23 (l)–10, inclusive.)

[2] Treasury Regulations 111 are applicable only to years beginning after December 31, 1941. Treasury Regulations 103, also promulgated under the Internal Revenue Code, are applicable to earlier years beginning after December 31, 1938. Sections 19.23 (a)–4, 19.23 (l)–1, 19.23 (l)–2, 19.23 (l)–4, 19.23 (l)–5, 19.113 (a)–1, 19.113 (a)–2 and 19.113 (b) (l)–1 of Treasury Regulations 103 do not differ from the corresponding provisions of Treasury Regulations 111, above quoted, in any material respect.

SEC. 29.23 (l)–1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23 (a)–15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. * * *

SEC. 29.23 (l)–2. *Depreciable Property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under section 29.23 (a)–15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the

growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the Internal Revenue Code. (See sections 23 (m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See section 29.23 (a)–4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under section 29.23 (a)–15 as held by the taxpayer for the production of income. No such allowance may be made in respect of automobiles or other vehicles used solely for pleasure, a building used by the taxpayer solely as his residence, or in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

SEC. 29.23 (l)–4. CAPITAL SUM RECOVERABLE THROUGH DEPRECIATION ALLOWANCES.—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113 (a) and 114.) To this amount should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis

of the depreciation allowance. (See section 113 (b).) * * *

SEC. 29.23 (l)–5. METHOD OF COMPUTING DEPRECIATION ALLOWANCE.—The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed. * * *

SEC. 29.113 (a)-1. SCOPE OF BASIS FOR DETERMINING GAIN OR LOSS.—The basis of property for the purpose of determining gain or loss from the sale or other disposition thereof is the unadjusted basis prescribed in section 113 (a), adjusted for the various applicable items specified in section 113 (b). Unless otherwise indicated, the word "basis," as used in this section and sections 29.113 (a)-2 to 29.113 (a) (22)-1, inclusive, has reference to the unadjusted basis. * * *

SEC. 29.113 (a)-2. GENERAL RULE.—In general, the basis of property is the cost thereof. This rule is subject, however, to the exceptions stated in sections 113 (a) (1) to 113 (a) (21), inclusive.

SEC. 29.113 (b) (1)-1. ADJUSTED BASIS: GENERAL RULE.—The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of such property or, in the case of such property as is described in section 113 (a) (1) to (21), inclusive, the basis therein provided, adjusted to the extent provided in section 113 (b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect to any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under

chapter 1 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.729–1. TIME AND PLACE FOR FILING RETURNS AND INFORMATION TO BE INCLUDED.—Excess profits tax returns shall be filed at the same time and place as the time and place prescribed in sections 53 and 235 and the income tax regulations under such sections for the filing of income tax returns. The excess profits tax return of a corporation of income received or accrued

(a) from the date of its incorporation to the end of its first accounting period, where the period between the date of incorporation and the end of such period is less than 12 months, or

(b) from the beginning of its last accounting period to the date it ceases operations and is dissolved, retaining no assets, where the period between the beginning of the accounting period and such date is less

than 12 months, shall be considered as a return for a fractional part of a year consisting of such period, and shall be filed within the time prescribed for filing returns for taxable years of less than 12 months.

The excess profits tax return shall be on Form 1121 (revised), and such return shall contain all the information required by such form and by these regulations with respect to computation of such tax. The return, however, requires the computation of the tax with only the credit which results in the lesser tax, and a return so filed meets the requirements of the statute. Thus a taxpayer may omit from the return the computation and information with respect to the excess profits credit under section 713 or section 714 which does not result in the lesser excess profits tax and may omit the computation and information with respect to the excess profits net income otherwise to be computed with such omitted credit. A return filed in this manner shall be audited as filed, regardless of whether it may be determined that the use of the omitted credit would result in a lesser tax. A corporation which files a return is not, by reason of the fact that only one method of computing its credit is employed, precluded from using the other method in the computation of its excess profits tax for such taxable year and, if an overpayment results, from filing a claim for the refund of such overpayment within the applicable period of limitation.

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